How emerging is your emerging markets manager?

Arguing for a bigger allocation to small caps

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Table of contents

Executive summary .................................................................................................................. 1
Introduction ........................................................................................................................... 2
Performance and prospects ................................................................................................. 3
Small-cap investing: A brief review ...................................................................................... 4
The elephants problem ......................................................................................................... 4
Historical returns of emerging market smaller caps .......................................................... 5
  Correlations of emerging market small caps with other equity categories ...................... 6
Small-cap stock characteristics ............................................................................................ 7
  Developed vs. emerging market revenue exposure of emerging market stocks ............... 7
  Valuations and growth rates ............................................................................................ 9
  Industrial mix .................................................................................................................. 10
Cross-sectional dispersion analysis ................................................................................... 11
Breadth ............................................................................................................................... 12
Analyst coverage ............................................................................................................... 12
Factor performance ........................................................................................................... 13
Roles of quantitative and fundamental analysis .............................................................. 14
Outlook and conclusion ....................................................................................................... 14
References ........................................................................................................................... 15

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Executive summary

Most of today’s sophisticated investors genuinely believe in the merits of a permanent allocation to emerging markets. It’s easy to see why: Projected rates of high economic growth, along with secular demographic and consumption trends, combine to offer the potential for high returns to the patient, long-term investor. Moreover, challenging conditions associated with many developed markets have investors scouring the world for growth.

We envision strong economies in many emerging markets for some time to come, and perhaps even an expansion of the emerging market country list to include many of today’s frontier markets. All of this spells opportunity.

With this as a point of departure, the question becomes: What is the best way to capture the full diversification benefits and high growth potential of emerging market equities? Empirical evidence argues for a broad approach that includes an allocation to all capitalization strata.

Emerging market small caps and large caps have been shown to behave quite differently, each offering unique characteristics to a global multi-asset-class portfolio. Investors allocating to emerging markets should be acquainted with the prevailing large-cap bias embedded in the most popular emerging market benchmarks, as well as with the impact of index fluidity—the way that benchmarks change as various countries come in and out of them.

Ultimately, if investors select a passive approach to emerging markets, they should realize what they are gaining—and leaving out—from a portfolio construction viewpoint. And even those preferring an active, fundamental approach to emerging market equities must look closely to ensure that their allocation is not unduly biased toward large-caps. Failure to do so could cause investors to miss out on what we believe to be the most interesting part of the emerging markets story: the diversifiers—companies that are typically more exposed to home-country economies and less exposed to global factors and developed-country competition.

Incidentally, these often innovative, nimble, and locally focused companies are frequently found at the lower end of the capitalization spectrum, outside the scope of most emerging market benchmarks.
Introduction

Emerging market countries include many of the fastest-growing economies in the world. How can investors best profit from this growth? Should they stay close to emerging market benchmarks, which select for size and liquidity, by either indexing or making carefully risk-controlled active bets? Or should they seek out the emerging market companies that they expect will maximize long-run performance, irrespective of company size?

This paper argues that investors can benefit from the opportunities in emerging markets by investing in smaller companies within those markets. First, investing in emerging market smaller caps broadens the opportunity set and improves diversification—these smaller companies being much more numerous. Second, compared to the largest-cap emerging market stocks, which often compete with developed-country companies in a global marketplace, smaller companies typically earn more of their sales and profits in local economies and are less impacted by global factors.

From a valuation standpoint, emerging markets—which have generally underperformed the U.S. in the economic recovery of the last six years—are a relative bargain. Yet some emerging market stocks are cheaper than others, and we believe that many overlooked opportunities are found among smaller caps. We recommend that investors who wish to construct well-diversified portfolios broaden the capitalization ranges of their holdings to include small- and medium-cap stocks, as well as the more widely held large caps, in emerging markets.

We first present some background information, including the historical returns, risks, and correlations of an emerging market small-cap index and comparisons to other widely held indexes. We then provide valuation and other fundamental information, showing how emerging market small caps expose the investor to different sectors and competitive forces than emerging market large caps. Finally, we demonstrate that emerging market small caps have historically had more dispersed returns, less analyst coverage, and larger payoffs from skillful factor analysis than emerging market large caps, making small caps attractive to alpha seekers.
Performance and prospects

One can argue that emerging markets should represent the world’s best investment opportunities. As countries transition from poor to middle-income and rich status, corporate sales, earnings, and dividends expand. Iconic examples are the United States from 1871 to 1929 (a 50-to-one increase in the real equity total return index) and Japan from 1950 to 1989. More recently, South Korea, eastern European countries such as Poland and the Czech Republic, and Chile, among others, have provided investors with similar returns during periods of rapid development. The long-term themes of globalization, industrialization, financial intermediation, and global manufacturing continue to be relevant.

Yet the recent performance of emerging market benchmarks has been disappointing when compared to that of the U.S. market, which decoupled from the rest of the world after 2011 and began rising sharply. The MSCI Emerging Markets Total Return Index is trading below its October 2007 high, during a period when U.S. equities, with dividends included, gained 58%. Emerging countries’ economies are not specifically to blame: despite recently slowing GDP growth, their GDPs have still grown much faster than those of either the U.S. or the rest of the sluggish developed world, which is still affected by the global financial crisis of 2007–2009. These emerging countries’ equity markets, or at least the cap-weighted benchmarks representing these markets, have lagged to a surprising degree, considering the intrinsic strength of the economies. With that backdrop, we look for ways that investors can participate in the opportunities afforded by higher growth rates in emerging countries.

Some have tried to benefit from economic growth in emerging market countries by buying developed market stocks that earn much of their profits in emerging markets. Companies such as Coca-Cola, John Deere, and Yum Brands have done very well as the consumer class has broadened in China and elsewhere. General Motors’s fastest growing market remains Asia. We have even seen U.S.-based service companies, such as banks and credit card operators, expand aggressively abroad.

But investing in such companies can be a diluted way of participating in emerging market growth. Most developed-market stocks are primarily exposed to developed market risks and growth rates. There are some exceptions, and successful active strategies have been crafted around the ability to pick them. But we seek a more systematic approach, one that unambiguously taps into emerging countries’ higher growth rates.

Thus, we suggest looking for opportunities among emerging market companies that generate most of their sales and profits locally. To find these companies, one must look below the mega caps, or big companies, with which most investors in emerging markets are familiar.
Small-cap investing: A brief review

The small-cap effect was discovered in the late 1970s by Reinganum [1981] and Banz [1981]. At the time, small caps were considered to provide consistently superior returns over the long term, but the return premiums for small caps provided to be highly cyclical. Still, small caps provide a substantially different return pattern than larger-cap stocks, with offering both the possibility of higher returns over the long term and the ability to diversify large-cap positions. As a result, investors today may favor small caps for any of the following reasons:

> Small caps perform well at different times than large caps, creating a diversification opportunity. In other words, the correlation between small and large caps is significantly less than one (see Exhibit 3 on page 7);
> The investor perceives small caps to have better growth prospects or more attractive valuations at a point in time;
> The investor perceives small caps to have superior long-run returns, or alpha, even if the realized premiums vary substantially across time.

A small-cap effect (either higher returns potential or favorable diversification properties, or both) has been found in most national markets, including emerging markets.4

The elephants problem

Emerging market investors face challenges not confronted by all investors. Most importantly, the emerging market country list contains an “elephants problem.” The largest emerging market country at a given time dominates emerging market indexes in a way that is disproportionate to the country’s importance in world markets; there’s nothing special about the country other than its being close to the border between emerging and developed. Then, when that country is promoted to developed market status, the indexes require massive rebalancing.

This elephants problem mirrors a more general large-cap bias in emerging market benchmarks and suggests that such benchmarks should be viewed skeptically when considered as guides to portfolio construction. We think active emerging market managers should use as broad an opportunity set as possible, even if it means making off-benchmark bets (see Grinold and Kahn [2000]).

South Korea has been on the threshold between emerging and developed market status for a long time; because index providers disagree, different emerging market indexes have materially different country weights depending on whether South Korea is in the index or not. Greece and Malaysia have floated in and out of the various emerging market indexes. Taiwan has a highly developed economy but is categorized as emerging because of restrictions on foreign ownership of shares. Some investors have even questioned China’s status as an emerging market index constituent because roughly 70% of the country’s market cap consists of state-owned enterprises (SOEs). China, Korea, and Taiwan now make up nearly half of the MSCI Emerging Markets Index.

There is also fluidity at the bottom of various emerging market benchmarks, at the border with frontier markets. For example, Argentina, clearly an emerging market by macroeconomic standards, floats in and out of emerging market and frontier market benchmarks due to concerns about capital controls. We do not believe investors should avoid a desirable company just because an index provider classifies its country of domicile as a frontier market; again, such off-benchmark bets can be fruitful.

3 The discoveries were in the late 1970s, but the articles were published in 1981.
4 See, for example, Neilsen [2007] for developed markets, and Rouwenhorst [1999] for emerging markets.
Because of these considerations, the returns of emerging market benchmarks are driven by a few large countries and a few large companies. As we’ll demonstrate, these returns are correlated to the global economy and to other factors that drive developed market equity returns—so emerging market benchmarks aren’t a particularly effective diversifier of developed market equity risk. Smaller-cap emerging market stocks, however, present quite a different return pattern and are good diversifiers.

We believe that the most interesting parts of the emerging market story are in the diversifiers—those companies or countries having less exposure to developed market risk factors. The mid-sized bank in South Korea, the food company in South Africa, and the robotics company in China all demonstrate higher growth and higher idiosyncratic risk than their large-cap peers.

Historical returns of emerging market smaller caps

We begin our investigation of the characteristics of emerging market small-cap equities by looking at their historical returns. Exhibit 1 shows the performance (cumulative total returns in U.S. dollars) of the MSCI emerging market small-, mid-, and large-cap indexes—along with the MSCI frontier-market indexes—from 2009 to 2014, a sharply bullish six-year period for equities worldwide. In addition, the exhibit shows U.S. (S&P 500) and developed market (EAFE) performance. Note that the S&P 500 beat all the other indexes, but just barely, with the MSCI Emerging Markets Small Cap ahead until the very end. All of the emerging market cap strata handily beat MSCI EAFE.

Exhibit 1
Total returns (in U.S. dollars) of emerging market equities by capitalization stratum, vs. other equity indexes, January 2009–December 2014

Past performance is no guarantee of future results.
Sources: RS Investments, FactSet, as of December 31, 2014.
Indexes are unmanaged and not available for direct investment and do not represent the performance of a single fund or any of the RS Investments Funds.
Within emerging markets, small caps beat mid caps, and mid caps beat large caps, over the six-year period, with most of the outperformance occurring in 2009–2010. The compound annual excess return of emerging market small caps over large caps was 4.4% over the period 2009–2014.

Longer-term performance of emerging market small caps has been slightly higher than that of emerging market large caps. Exhibit 2 shows results over 1995–2014. The compound annual rate of outperformance (of small- over large-cap emerging market stocks) was 0.41%. Although Exhibit 2 does not clearly show relative performance within emerging markets, returns were sometimes materially different for the cap strata. The two periods of substantial underperformance for emerging market small caps were 1997–1999, during the tech boom, when large caps tended to do very well, and 2007–2008, when the great emerging markets boom of 2003–2007 was coming to a close and the global financial crisis was spreading. Emerging market small caps outperformed much of the rest of the time, especially in the rebound after the financial crisis.

**Correlations of emerging market small caps with other equity categories**

The ability of one asset class to diversify the risk of holding others is shown by the correlation matrix of returns. Exhibit 3 shows the correlations, in U.S. dollars, small-, mid-, and large-cap emerging market stocks with various other major equity categories over 1994–2014.

We see that the correlations of the top-cap emerging market stock index relative to the MSCI EAFE and MSCI ACWI exceed 0.8, while the correlations of the smallest-cap emerging market stock index to those same indexes are all below 0.8, and below 0.7 for the S&P 500 Index.
Small-cap stock characteristics

In this section, we will compare emerging market small-cap stocks to other stocks in terms of their revenue exposure to various geographic markets, their valuation and growth metrics, and their industrial or sector mix.

Developed vs. emerging market revenue exposure of emerging market stocks

Exhibit 4 compares developed and emerging market revenues (sales) of emerging market companies.

We see that emerging market small-cap stocks have lower exposure to the developed markets, as measured by revenue, than emerging market large-cap stocks. Emerging market large-cap stocks earned 21% of their revenues in developed market countries, but emerging market small caps (the rest of the stocks) earned only 12% of their revenues in developed market countries.

On a company-by-company basis, however, there are some significant standouts. Of the 456 large-cap companies in the MSCI Emerging Markets Large Cap Index, 56 have developed markets revenues that exceed 40% of total revenues. Exhibit 5 shows details on the largest companies with developed markets revenue exposure. Many are popular holdings in emerging markets funds marketed to U.S. investors.
In these emerging market large-cap stocks, exposure to North America is largely in the areas of information technology and energy. A large portion of emerging market exposure to Europe is the result of European energy imports from Russia. A number of regional and sector themes can also be identified: telecommunications, Taiwanese and South Korean semiconductors and, the global handset value chain (Samsung, Hon Hai). A longer list of emerging market large-cap stocks with large developed markets exposure would have, as prominent themes, Indian technology and service companies, South African and Brazilian base metals, the global steel industry, and the rising giant of Chinese banking.

The data in Exhibits 4 and 5 support our contention that emerging market small caps are more exposed than emerging market large caps to the world’s fastest-growing local markets, which are almost without exception emerging markets. Because of this relationship, we see the

### Exhibit 5
Emerging market large-cap companies with significant developed markets revenue exposure

<table>
<thead>
<tr>
<th>COMPANY NAME</th>
<th>ASIA &amp; PACIFIC DEVELOPED</th>
<th>EUROPE &amp; MIDDLE EAST DEVELOPED</th>
<th>NORTH AMERICA DEVELOPED</th>
<th>DEVELOPED MARKETS TOTAL</th>
<th>TOTAL MARKET CAP (US $MILLION)</th>
<th>% OF DEVELOPED REVENUE IN MSCI EMERGING MARKETS INDEX</th>
</tr>
</thead>
<tbody>
<tr>
<td>LUKOIL OAO</td>
<td>0.4</td>
<td>69.9</td>
<td>6.9</td>
<td>77.2</td>
<td>31,542</td>
<td>9.10</td>
</tr>
<tr>
<td>SAMSUNG ELECTRONICS CO., LTD.</td>
<td>9.3</td>
<td>17.0</td>
<td>25.5</td>
<td>51.7</td>
<td>199,418</td>
<td>8.86</td>
</tr>
<tr>
<td>HON HAI PRECISION INDUSTRY CO., LTD. (FOXCONN)</td>
<td>16.8</td>
<td>35.7</td>
<td>30.4</td>
<td>82.8</td>
<td>41,147</td>
<td>8.82</td>
</tr>
<tr>
<td>GAZPROM OAO</td>
<td>0.0</td>
<td>41.1</td>
<td>0.0</td>
<td>41.1</td>
<td>51,415</td>
<td>4.67</td>
</tr>
<tr>
<td>HYUNDAI MOTOR CO., LTD.</td>
<td>1.6</td>
<td>17.4</td>
<td>25.7</td>
<td>44.8</td>
<td>33,869</td>
<td>3.11</td>
</tr>
<tr>
<td>JBS SA</td>
<td>4.5</td>
<td>0.6</td>
<td>57.6</td>
<td>62.7</td>
<td>12,403</td>
<td>2.55</td>
</tr>
<tr>
<td>RELIANCE INDUSTRIES LTD.</td>
<td>6.7</td>
<td>16.4</td>
<td>17.2</td>
<td>40.4</td>
<td>45,672</td>
<td>2.11</td>
</tr>
<tr>
<td>KIA MOTORS CORP.</td>
<td>0.3</td>
<td>20.6</td>
<td>33.6</td>
<td>54.4</td>
<td>19,288</td>
<td>1.89</td>
</tr>
<tr>
<td>QUANTA COMPUTER, INC.</td>
<td>7.5</td>
<td>19.7</td>
<td>46.6</td>
<td>73.8</td>
<td>9,680</td>
<td>1.74</td>
</tr>
<tr>
<td>PEGATRON CORP.</td>
<td>6.6</td>
<td>29.9</td>
<td>30.1</td>
<td>66.6</td>
<td>5,378</td>
<td>1.70</td>
</tr>
<tr>
<td>LENOVO GROUP LTD.</td>
<td>9.2</td>
<td>15.9</td>
<td>16.1</td>
<td>41.1</td>
<td>14,611</td>
<td>1.53</td>
</tr>
<tr>
<td>TAIWAN SEMICONDUCTOR MANUFACTURING CO., LTD.</td>
<td>8.2</td>
<td>4.0</td>
<td>64.8</td>
<td>77.0</td>
<td>115,689</td>
<td>1.51</td>
</tr>
<tr>
<td>COMPAL ELECTRONICS, INC.</td>
<td>7.4</td>
<td>25.6</td>
<td>34.7</td>
<td>67.7</td>
<td>3,106</td>
<td>1.49</td>
</tr>
<tr>
<td>SURGUTNEFTEGAS OJSC</td>
<td>5.2</td>
<td>51.4</td>
<td>3.0</td>
<td>59.6</td>
<td>17,791</td>
<td>1.28</td>
</tr>
<tr>
<td>TATA MOTORS LTD.</td>
<td>6.3</td>
<td>22.3</td>
<td>12.8</td>
<td>41.4</td>
<td>23,734</td>
<td>1.17</td>
</tr>
<tr>
<td>TATA STEEL LTD.</td>
<td>4.4</td>
<td>47.1</td>
<td>2.7</td>
<td>54.3</td>
<td>6,144</td>
<td>1.00</td>
</tr>
</tbody>
</table>

Sources: FactSet, MSCI, as of December 31, 2014.
potential for superior earnings growth from these smaller companies and, if market valuations keep up with fundamentals, superior market performance.

Valuations and growth rates
After more than six years of fiscal and monetary stimulus in the developed world, developed market equities are not cheap. Emerging market stocks have lagged and, as a result, emerging market valuations are now more attractive than valuations in the developed world. Furthermore, emerging market small caps have notably attractive valuations. Exhibit 6 shows fundamental characteristics for benchmarks of each of these markets.

Trailing P/E ratios in Exhibit 6 favor emerging markets over developed markets, and forward P/E ratios do favor emerging market small caps, albeit not dramatically.

When assessing valuations, however, one should look at growth as well as value metrics—and earnings growth is expected to be much faster for emerging market small caps than for other equity categories. Therefore, emerging market small cap stocks should carry a higher valuation relative to emerging market large cap stocks—and other stocks elsewhere in the world—because of their higher growth rates. Given that they are priced comparably to emerging market large-cap stocks, and are cheaper than developed market stocks, this suggests that they represent good value.

Industrial mix
One source of diversification in emerging market small caps is the fact that the industrial or sector mix differs relative to other equity asset classes. Exhibit 7 com-

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**Exhibit 6**
Key index statistics: Emerging market small caps have the most attractive valuations

<table>
<thead>
<tr>
<th></th>
<th>MSCI EM</th>
<th>MSCI EMERGING MARKETS SMALL CAP</th>
<th>MSCI EAFE</th>
<th>MSCI ALL-COUNTRY WORLD</th>
<th>S&amp;P 500</th>
</tr>
</thead>
<tbody>
<tr>
<td>EPS GROWTH (%)—TRAILING 12 MONTHS</td>
<td>15.0</td>
<td>25.2</td>
<td>13.6</td>
<td>16.8</td>
<td>13.0</td>
</tr>
<tr>
<td>EPS GROWTH (%)—ESTIMATED 3–5 YEAR FORWARD</td>
<td>13.8</td>
<td>17.2</td>
<td>9.8</td>
<td>11.2</td>
<td>11.2</td>
</tr>
<tr>
<td>MARKET CAP—AVERAGE (US$MILLION)</td>
<td>11,229.5</td>
<td>711.5</td>
<td>18,287.5</td>
<td>19,836.1</td>
<td>39,067.9</td>
</tr>
<tr>
<td>MARKET CAP—MEDIAN (US$MILLION)</td>
<td>5,471.0</td>
<td>558.2</td>
<td>8,706.2</td>
<td>8,859.0</td>
<td>18,697.0</td>
</tr>
<tr>
<td>P/E BASED ON FORECAST 2015 EARNINGS</td>
<td>11.1</td>
<td>10.9</td>
<td>14.1</td>
<td>14.9</td>
<td>16.4</td>
</tr>
<tr>
<td>P/E BASED ON TRAILING 12-MONTH EARNINGS</td>
<td>12.3</td>
<td>12.8</td>
<td>16.3</td>
<td>16.8</td>
<td>19.2</td>
</tr>
<tr>
<td>PRICE/BOOK</td>
<td>1.5</td>
<td>1.3</td>
<td>1.6</td>
<td>2.0</td>
<td>2.7</td>
</tr>
<tr>
<td>PRICE/CASH FLOW</td>
<td>5.9</td>
<td>6.2</td>
<td>7.5</td>
<td>8.8</td>
<td>11.2</td>
</tr>
<tr>
<td>DIVIDEND YIELD (%)</td>
<td>2.7</td>
<td>2.4</td>
<td>3.1</td>
<td>2.4</td>
<td>1.9</td>
</tr>
<tr>
<td>REVENUE GROWTH—3 YEAR HISTORICAL</td>
<td>14.5</td>
<td>21.6</td>
<td>4.6</td>
<td>7.8</td>
<td>6.2</td>
</tr>
</tbody>
</table>

Past performance is no guarantee of future results.
Source: FactSet, as of December 31, 2014. Indexes include gross (before-tax) dividends.
pares sector weights in emerging market small caps to those in emerging markets overall.

Note that emerging market large-cap stocks are heavily tilted toward telecommunications, technology, and energy. América Movil (Mexico), Samsung Electronics (South Korea), and Lukoil (Russia) are cases in point. Emerging market small caps (including mid caps) are much more heavily weighted in the consumer and industrial sectors, and are thus more closely linked to domestic emerging market economies.

Telecom services, which are often national monopolies, practically disappear in the MSCI Emerging Markets Small Cap Index. Energy companies are also much less prevalent in small cap; and financials, while still a large share of the benchmark, are less important in small cap. Finally, and perhaps surprisingly since U.S. investors tend to think of health care companies as big, health care stocks plays a larger role in emerging market small cap than in large caps.

We’d also note—although it’s not visible in Exhibit 6—that some emerging market large-cap companies are acquiring developed market companies, so that investing in emerging market large caps produces hidden developed market exposure. For example, Tata Motors (India) bought Jaguar Land Rover from Ford, and Vale S.A. (Brazil) bought Inco (Canada).

The weights in Exhibit 7 are based on stock prices, which discount profits, not sales. This is in contrast to Exhibit 4, which focuses on sales. The two exhibits, taken together, show a fairly strong relationship between capitalization and exposure to emerging and faster-growing economies.

**Exhibit 7**
Sector weights in MSCI emerging market large- and small-cap indexes

Sources: RS Investments, FactSet, as of December 31, 2014.
Cross-sectional dispersion analysis

One indicator of the amount of alpha generation opportunity an asset class affords its investors is the cross-sectional dispersion of the returns of the stocks in the asset class. If all the stocks were perfectly correlated with one another, the asset class would in effect consist of one security and there would be no opportunity to add value through security selection. As these correlations decrease, the opportunity to add alpha increases.5

Note that there is nothing in this analysis that says a particular manager is going to come out in the top half of the distribution of alphas. No matter how inefficient a market is, or how much opportunity is afforded by the cross-sectional dispersion of returns, active management versus a properly chosen benchmark is still a zero-sum game, with half of all managers underperforming the benchmark before costs, and more than half underperforming after costs.6

One way to visualize the difference in alpha generation opportunities between the emerging market small- and large-cap asset classes is to look at the dispersion (standard deviation) of monthly security returns for the two categories. We conduct this analysis in Exhibit 8, with each month from January 2009 to December 2013 shown separately. The monthly results are then connected by a light blue line (emerging market small caps) or a dark blue line (emerging market large caps).

The exhibit shows clearly that dispersion was higher for emerging market small caps. In fact, it was higher in nearly every month!

Exhibit 8
Month-by-month cross-sectional standard deviations of one-month returns on stocks in the emerging market small cap and emerging market large cap benchmarks, 2009–2014

Past performance is no guarantee of future results. Indexes are unmanaged. It is not possible to invest directly in an index.

Sources: RS Investments, FactSet, as of December 31, 2014.

Large- and small-cap universes include MSCI Emerging Markets Index and S&P Emerging Plus BMI constituents.

Dispersion is standard deviation of monthly returns.

5 In a well-known study, Jones and Wermers [2011] found that realized alpha was related to return dispersion for U.S. stocks. This result suggests that a similar effect may prevail in other markets, and Yu andSharaiha [2007] argue that it exists for European equities. We do not know of a study of this phenomenon as it applies specifically to emerging markets.

6 This well-known (and unfortunately correct) analysis is due to Sharpe [1991].
Breadth

We can look at the challenge facing active managers through the prism supplied by Richard Grinold and Ronald Kahn [2000] in their classic work on “breadth.” They showed that, for a given amount of active management skill, performance is higher in proportion to the square root of the number of independent decisions—such as security selection decisions—to which the skill is applied. (See our earlier work, Siegel and Scanlan [2014].)

Taking the MSCI Emerging Markets Large Cap Index as the measure of large caps and the MSCI Emerging Markets Mid Cap Index and Emerging Markets Small Cap Index combined to represent smaller caps, large caps comprise 456 names, while smaller caps comprise 2,164 names. So an active manager in emerging market smaller caps has almost five times as many stocks to choose from, or (applying the square root rule) 2.2 times as much opportunity to apply his or her skill, just based on the number of names. In addition, the emerging market smaller stocks have lower cross-correlations and significantly higher volatility. So there are many more opportunities for emerging market small-cap managers to differentiate themselves from the benchmark and from other managers, relative to large-cap managers.

We’d also note that it’s difficult for emerging market managers with a large quantity of assets under management (AUM) to take advantage of opportunities in smaller-cap emerging market stocks. Such managers typically hold mostly, or only, emerging market large-cap companies, and may also invest in developed market companies believed to offer emerging market exposure.

Investors in some of the popular, high-AUM funds may not be getting the diversification benefit they think they’re getting.

Thus, investors in some of the popular, high-AUM funds may not be getting the diversification benefit they think they’re getting.

Analyst coverage

Many investors believe—and this view seems logical to us—that companies which are widely followed by security analysts are more efficiently priced than those followed by few analysts. Exhibit 9 shows that coverage is much deeper for large than for smaller caps.

Exhibit 9
Sell-side analyst coverage of emerging market stocks


7 The concept of breadth originates with an earlier [1989] article by Grinold.
8 We are not aware of any academic studies directly relating analyst neglect to higher returns. However, the studies that address this question, particularly Beard and Sias [1997], are looking for (and, after adjusting for the small-cap effect, not finding) an association between the entire population of neglected stocks and higher return. For our proposition regarding analyst coverage to “work,” only those stocks that would be found attractive by an analyst—by construction, probably no more than half of the population—would need to have a higher return. In other words, Beard and Sias did not (and did not try to) overturn the idea that there is greater alpha opportunity in neglected stocks.
Factor performance

We now look at the relationship between analyst forecasts and stock returns. Successful active management depends on the manager’s ability to convert publicly available information into alpha. This is only possible when such information produces signals that are strong enough for managers to use on a reasonably consistent basis.

To see if this is the case for emerging market small caps, we calculated the information coefficient (IC) for one factor believed to be important in affecting equity returns in this asset class. The factor is “earnings revisions” (changes in average or consensus forecasts of company earnings made by sell-side analysts). The results of this analysis are in Exhibit 10, with small caps represented by the four bars on the left and large caps represented by the four bars on the right. The ICs in the exhibit are correlations between earnings revisions, as defined above, and the subsequent monthly return on the stock.9

Because forecasting earnings is inherently difficult, the ICs shown in the exhibit for emerging market small caps, around 0.05, are satisfyingly large and reflect a substantial opportunity for alpha generation. For emerging market large caps, the ICs are less than one-third as large. The exhibit shows that revisions in analysts’ consensus earnings forecasts for emerging market small caps are a more powerful predictor of future returns than they are for emerging market large caps.10

Exhibit 10
Correlations between earnings revisions and subsequent one-month returns for emerging market large- and small-cap stocks, December 2006–November 2014

Sources: RS Investments, FactSet, as of December 31, 2006—November 30, 2014
Note: FY1—forecasts of the next fiscal year’s earnings, e.g. forecasts of 2015 earnings made in 2014; FY2—forecasts of the subsequent fiscal year’s earnings, e.g. forecasts of 2016 earnings made in 2014. Because the IC is a correlation, it ranges from -1 to +1, where zero shows no relation between earnings revisions (changes in the consensus of analyst forecasts) and subsequent one-month stock returns, and +1 shows a perfect positive relationship.
Data captures the information coefficient, calculated monthly, of large- and small-cap companies within MSCI Emerging Markets Index and the S&P Emerging Plus BMI.

9 Earnings revisions are defined as the simple average of sell-side analysts’ earnings forecasts as reported by I/B/E/S, a Thomson Reuters service, minus the simple average of the forecasts made 3 or 6 months earlier.
10 It is interesting that these relatively favorable results were obtained entirely with public information (the analysts’ forecasts being accessible by any I/B/E/S subscriber). An active manager with a skill in making non-consensus forecasts could presumably do even better.
Roles of quantitative and fundamental analysis

While we've noted the considerable diversification benefit and alpha opportunity in emerging market small caps, it is still necessary to analyze stocks effectively in this under-researched area. Many of these companies have little Wall Street research coverage. A quantitative approach can highlight where inefficiencies lie, and flag stocks that demonstrate attractive growth and valuation characteristics in a systematic and efficient manner.

However, to evaluate the validity and sustainability of these factors, a manager should perform fundamental analysis to assess the impact of qualitative factors on business fundamentals and earnings, the sustainability of the growth profile, and the stock’s valuation. In addition, fundamental research can help to forecast earnings revisions and positive surprises that catalyze movements in the stock price.

Outlook and conclusion

While emerging markets are growing more slowly than in the heroic years in the middle of the last decade, they are still the fastest-growing economies in the world. Meanwhile, developed markets are more stagnant than they have been over any extended period since the Great Depression. Thus, any advantage that small caps have in terms of emerging market economic exposure is likely to translate into higher earnings growth rates over this globally difficult economic period.

Sooner or later, we expect that the current global stagnation will work itself out. As one of us has passionately argued, there is no fundamental reason why per capita income growth—which is what counts for human development—should be slower in the future than it was in the past. New ideas and technologies are the main source of per capita income growth, and there is no reason to think the human race is running out of ideas. Population growth is slowing, but stabilization of the world population is a good thing (consider the alternative)—it makes economic growth easier by lightening environmental and resource pressures.

But some will gain and some will lose, at least in relative terms. We envision a strong economy in emerging markets, and an expansion of the emerging market country list to include many of today's frontier markets, for quite some time to come. We believe developed markets will continue to face competition from these rising stars.

A well-diversified portfolio includes all capitalization strata. Emerging market small caps and large caps are quite different, and each contributes unique characteristics and opportunities to a global multi-asset-class portfolio. In the context of global asset pricing, emerging markets are a bargain, and, within emerging markets, smaller caps are both faster-growing and attractively valued. Therefore, investors in search of high prospective returns should take a careful look at incorporating emerging market small caps into their portfolios.
References


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Are you missing out on the most interesting part of the emerging markets story?

Learn how emerging market smaller caps—which are more numerous than large caps and have less analyst coverage—can broaden the opportunity set and improve diversification.

Sell-side analyst coverage of emerging market stocks

Sources: RS Investments, FactSet, as of December 31, 2014.
Universe includes MSCI Emerging Markets Index and S&P Emerging Plus BMI constituents. Dispersion is standard deviation of monthly returns.